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In the Supreme Court of the United States

OCTOBER TERM, 1983

AMERICAN INTERNATIONAL COAL CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT*

**MEMORANDUM FOR THE RESPONDENT
IN OPPOSITION**

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TABLE OF AUTHORITIES

	Page
Cases:	
<i>Commissioner v. Court Holding Co.,</i> 324 U.S. 331	4
<i>Frank Lyon Co. v. United States,</i> 435 U.S. 561	4
<i>Griffiths v. Commissioner,</i> 308 U.S. 355	4
<i>Higgins v. Smith,</i> 308 U.S. 473	4
Statute:	
Internal Revenue Code of 1954, 26 U.S.C. 162(a)(1)	3

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Petitioner in this federal income tax case seeks review of the decision of the court of appeals, holding that the \$50,000 petitioner paid to Stephen Levitt, an employee and shareholder, was a nondeductible distribution in redemption of his stock rather than a deductible payment for services rendered by him.

1. Petitioner is a Pennsylvania corporation engaged in the business of supplying coal under contract (C.A. App. 31).¹ The corporation was owned equally by Stephen Levitt and Richard Schomaker, each holding 1000 shares of petitioner's stock (*ibid.*). Levitt also was an employee of petitioner; his job was to negotiate coal supply contracts (*id.* at 191).

¹"C.A. App." refers to the appendix filed with the court of appeals.

In September 1975, Levitt, for personal reasons, was required unexpectedly to terminate his relationship with petitioner (C.A. App. 197). As a consequence, Levitt reviewed petitioner's books and determined that his interest in the corporation was worth \$50,000 (*id.* at 198). Accordingly, he issued himself a check in that amount, noting on the stub that the check was in payment for his stock, and arranged for the check to be presented to Schomaker for his countersignature, which was required for the check to be negotiable (*id.* at 200).

Schomaker, an attorney, objected to the statement on the check that it was payment for stock and declined to sign it (C.A. App. 200-201). Instead, in negotiations with Levitt's counsel, Schomaker proposed that petitioner pay Levitt the \$50,000 as commissions and redeem Levitt's stock for \$1,000. Further, Schomaker proposed to pay Levitt an additional \$12,000 in installments, which would also be characterized as commissions (*id.* at 128-129).

Levitt's only concern in these negotiations was to obtain the \$50,000 as quickly as possible; he was not concerned with how the transaction was characterized (C.A. App. 201). Accordingly, a Termination Agreement and an Agreement of Sale, as proposed by Schomaker, were entered into between petitioner and Levitt (*id.* at 58-59, 65-68). Pursuant to the agreements, Schomaker changed the notation on the check stub to indicate that the \$50,000 was being paid as commissions and then he countersigned a check payable to Levitt (*id.* at 270).

On its 1975 federal income tax return, petitioner deducted \$54,800, as commissions paid to one of its employees

(C.A. App. 38-45).² The Commissioner disallowed this deduction and issued a notice of deficiency (*id.* at 4-6).³

2. Petitioner filed a petition for redetermination with the Tax Court. That court held that the \$50,000 payment was in redemption of Levitt's stock and therefore not deductible by petitioner as a business expense under Section 162(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.), but that the \$4,800 was compensation to Levitt and therefore deductible (C.A. App. 262-290).⁴ With regard to the \$50,000, the court found that the amount paid by petitioner was a close approximation of the actual value of Levitt's stock (*id.* at 281), that Levitt originally understood the payment to be in redemption of stock (*ibid.*) and that Levitt had been adequately compensated for his services by his weekly salary and fringe benefits (*id.* at 282). Accordingly, the court concluded that the Termination Agreement and Agreement of Sale, which characterized the \$50,000 as a commission, did not reflect "the substance and reality of the transaction" between Levitt and petitioner (*id.* at 286), and accordingly that petitioner was not entitled to deduct the \$50,000.⁵

The court of appeals affirmed by order, finding that the Tax Court's decision was "supported by substantial evidence" (Pet. App. 1a).

²This figure includes the \$50,000 check and a \$4,800 installment payment, which was characterized as a commission (C.A. App. 271).

³The Commissioner also disallowed \$4,025 of petitioner's deduction for theft loss (C.A. App. 6). Petitioner did not challenge that deficiency in the Tax Court (*id.* at 262 n.1).

⁴The Commissioner did not cross-appeal from the Tax Court's determination that the \$4,800 was compensation.

⁵The Tax Court recognized that ordinarily the fact that the proposed transaction was, as a tax matter, disadvantageous to Levitt—it would make the \$50,000 taxable as ordinary income instead of as capital gain—would be enough to deter him from agreeing to the tax avoidance

3. Petitioner's principal argument (Pet. 23-40) is that under *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the courts below were required to honor the form in which the parties chose to cast their transaction and that the agreements between petitioner and Levitt indicated that the \$50,000 payment was compensation. This argument is plainly without merit.

In *Frank Lyon Co.*, this Court sustained the finding of the district court that there had been arm's-length bargaining between the parties and that the form of the transaction at issue reflected its economic substance (435 U.S. at 577). In the instant case, the Tax Court, in findings upheld by the court of appeals, determined, that because of the circumstances of Levitt's departure there was no real arm's-length bargaining between the parties and that petitioner's characterization of the \$50,000 as commissions did not reflect the true substance of the transaction. Contrary to petitioner's claim, the decision below is fully consistent with *Frank Lyon Co.* and similar decisions of this Court, which have held that the tax consequences of a particular transaction ultimately depend on the economic reality of that transaction. See *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Higgins v. Smith*, 308 U.S. 473 (1940); *Griffiths v. Commissioner*, 308 U.S. 355 (1939). Since the determination of the courts below that the \$50,000 was in redemption

scheme proposed by Schomaker. But the court held that, in the unusual circumstances surrounding Levitt's desire to terminate the relationship as quickly as possible, he did not care how the transaction was characterized so long as he received the money expeditiously (C.A. App. 273, 283).

of stock is purely factual and fully supported by the record,⁶ it plainly does not warrant review by this Court.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

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⁶Petitioner argues (Pet. 40-42) that the Commissioner has taken an inconsistent position in the instant case because Levitt reported the \$50,000 as ordinary income on his income tax return. The Commissioner, however, has not had occasion to take any position with regard to Levitt's treatment of the \$50,000 since Levitt has never sought a refund.